Brinker Capital

Market & Economic Outlook

October 2016

Market/Economic Review and Outlook

The third quarter was marked by a continuation of global growth with risk assets posting strong returns. Despite the shock of Brexit at the end of the second quarter, investor fears quickly dissipated as they realized Brexit would likely be a protracted process. A risk-on environment was resumed and markets rallied in early July. Expectations for the next Fed rate hike moved from September to December, further fueling risk assets. Data such as stronger wage growth, low inflation and low unemployment levels leads us to believe that while we are likely late in the business cycle, there is still room for growth before the next recession. However, risks such as the upcoming presidential election and possibility of a central bank policy mistake are still very much present within the economy and will likely result in more volatile markets.

The S&P 500 Index gained 3.8% for the quarter. Cyclical sectors posted strong returns with notable performance from the information technology sector (+12.9%). Defensive sector performance was mostly negative with only the healthcare (+0.9%) sector ending in positive territory. The higher yielding sectors, telecom, utilities and consumer staples sectors were negative for the quarter as income oriented strategies came under pressure with talk of another Fed rate hike. Growth outperformed value but continues to lag value year-to-date. Small cap outperformed large and mid-cap for the quarter, and leads year-to-date.

International equity markets rallied in the third quarter, outperforming domestic equities. Developed international equities were up 6.5% as markets recovered from volatility stemming from the Brexit decision in late June. However, the presence of negative interest rate policies and consideration of the effectiveness of quantitative easing programs continues to create uncertainty within the developed international markets. Emerging markets generated a strong positive return of 9.2% for the quarter, driven by stabilization in emerging market currencies and commodity prices as well as signs of political reform in countries such as Brazil. After strong negative sentiment surrounded emerging markets coming into 2016, the asset class has lead developed markets with a year-to-date return of more than 16%.

The Bloomberg Barclays US Aggregate Index was up 0.5% for the quarter with sector performance mixed. Treasuries were down -0.3% as yields, after reaching a record low following the Brexit decision, rose in response to hawkish comments from the Fed in early September. Negative returns were somewhat tempered as the Fed's decision to once again not raise rates sparked a bond rally late in the quarter. The 10 year Treasury yield ended the quarter at 1.6%. Credit spreads continued to contract, resulting in a gain of 5.5% in the high yield sector. Municipal bonds moved sideways, generating a flat return for the quarter.

U.S. economic data releases have been mixed, but lean positive. Yet, with better economic data comes the possibility of an additional Fed interest rate hike sooner rather than later. There is a high probability that the next move will take place in December. However, Fed rhetoric may create the dynamic where "good news is bad news." While the possibility of a rate hike could adversely affect markets in the near term, it doesn't change our positive intermediate term outlook. Aside from the Fed, the actions of the ECB and Bank of Japan will also have an impact on markets.

While our outlook remains positive over the intermediate-term, we acknowledge that we are in the later innings of the bull market and the second half of the business cycle. We find a number of factors supportive of the economy and markets over the near term:

Global monetary policy remains accommodative: The Fed's approach to tightening monetary policy has been patient. The Bank of Japan and the ECB remain supportive, and the Bank of England may need to join in response to the Brexit vote.

Stable U.S. growth and tame inflation: U.S. economic growth has been modest but steady. Wage growth has ticked higher, but reported inflation and inflation expectations remain in check.

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U.S. fiscal policy more accommodative: Fiscal policy is modestly accommodative in 2016, helping offset more restrictive monetary policy. In addition, we could see expansionary fiscal policy come out of the newly elected Administration to help offset the fiscal drag expected in 2017.

Constructive backdrop for U.S. consumer: The U.S. consumer should continue to benefit from lower oil prices and a stronger labor market, as well as low mortgage rates.

However, risks facing the economy and markets remain, including:

Risk of policy mistake: In the U.S., the subsequent path of rates is uncertain and may not be in line with market expectations, which could lead to increased volatility. The ECB and the Bank of Japan could also disappoint market participants, bringing the credibility of central banks into question.

Slower global growth: Economic growth outside the U.S. is weaker.

Presidential election uncertainty: The election will weigh on investors leading up to November. Depending on the rhetoric, certain sectors could be more impacted than others.

The technical backdrop of the market has improved, as have credit conditions, helped by the favorable macroeconomic environment. Investor sentiment moved from extreme pessimism levels in early 2016 back into more neutral territory, and we still haven't seen significant inflows into equity markets. Valuations are at or slightly above historical averages, but we need to see earnings growth reaccelerate. We expect higher volatility to continue as we digest the actions of central banks; but our view on risk assets still tilts positive over the near term. Higher volatility can lead to attractive pockets of opportunity we can take advantage of as active managers.

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